



International Business Machines Corp. (IBM)

Updated July 29th, 2019 by Prakash Kolli

Key Metrics

Current Price:	\$151	5 Year CAGR Estimate:	9.3%	Volatility Percentile:	40.5%
Fair Value Price:	\$167	5 Year Growth Estimate:	3.0%	Momentum Percentile:	53.2%
% Fair Value:	90%	5 Year Valuation Multiple Estimate:	2.0%	Growth Percentile:	14.0%
Dividend Yield:	4.3%	5 Year Price Target	\$193	Valuation Percentile:	76.5%
Dividend Risk Score:	B	Retirement Suitability Score:	A	Total Return Percentile:	61.3%

Overview & Current Events

IBM is a global information technology company that provides integrated enterprise solutions for software, hardware and services. IBM's focus is large, multi-national customers and running mission critical systems. IBM typically provides end-to-end solutions. In the services business, IBM is the world's largest IT provider with 5.5% market share. In software, IBM's software business is mostly middleware, which is the software layer that connects applications and devices to each other. In hardware, IBM sells the zSystem mainframes, storage, and the Power-based servers. The company has five business segments: Cloud & Cognitive Software, Global Business Services, Global Technology Services, Systems, and Global Financing. IBM generated annual revenue of ~\$80B in 2018 and has a market capitalization of \$134.2B.

IBM reported mixed Q2 2019 results on June 21, 2019. The company missed revenue estimates but beat GAAP EPS estimates. Companywide revenue was down 4.2% to \$19,161M from \$20,003M on year-over-year basis. Due to IBM's global operations, the company continues to face significant foreign exchange headwinds. Diluted GAAP EPS grew 8% to \$2.81 in the quarter from \$2.61 from the prior year. Revenue for Cognitive & Software increased 3.2% (5.4% constant currency) to \$5,645M from \$5,470M in comparable quarters due to growth in cloud and data platforms, cognitive applications, and transaction processing. Revenue for Global Business Services grew 0.5% (3.4% constant currency) to \$4,155M from \$4,135M on year-over-year basis on the strength of consulting. Revenue for Global Technology Services declined 6.7% (3.5% constant currency) to \$6,837M in Q2 2019 from \$7,325M in Q2 2018. Revenue for Systems declined 19.5% (18.0% constant currency) to \$1,753M from \$2,177M in comparable quarters due to the business cycle of the zSystem and storage systems offset by growth in operating systems software and POWER9. Global Financing revenue was down 11.0% (8.5% constant currency) to \$351M reflecting wind-down of OEM commercial financing. Of concern is that IBM's backlog decreased 4% to \$111.2B.

IBM is expected to close the Red Hat acquisition on August 2nd for \$34B. Red Hat has a leading position in hybrid cloud, which would in turn make IBM the No. 1 provider of hybrid cloud solutions. The deal is expected to be accretive to cash flow in the first year and non-GAAP EPS by the end of the second year. Red Hat will operate as a distinct unit within IBM.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	\$10.01	\$11.52	\$13.06	\$14.37	\$14.94	\$15.59	\$13.60	\$12.39	\$13.66	\$13.81	\$13.90	\$16.11
DPS	\$2.15	\$2.50	\$2.90	\$3.30	\$3.70	\$4.25	\$5.00	\$5.50	\$5.90	\$6.60	\$6.93	\$8.84
Shares	1305	1228	1163	1117	1054	990	965	946	922	892	892	840

IBM's core operations are highly profitable. But IBM has had difficulty generating top and bottom line growth in the past several years. Some of the challenges have been due to the transition to cloud and SaaS in the IT industry and lack of meaningful growth from initiatives such as Watson. However, IBM is now focusing on cloud and SaaS and intends to be a major player in hybrid cloud as illustrated by the Red Hat acquisition. We are forecasting flat revenue growth in 2019 and then on average 3% annually out to 2024. The dividend has grown at double-digit rates in the past 10 years.

However, the dividend payout ratio is near 50% and the company is increasing long-term debt for the Red Hat purchase. We forecast on average 5% annual growth of the dividend out to 2024. IBM has significantly reduced the share count in the past 10 years. But due to the impending acquisition we are not expecting any share buybacks in 2019 and 2020.

Disclosure: This analyst is long IBM.



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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	10.9	11.4	13.1	13.7	13.0	11.7	11.4	12.1	13.1	8.2	10.9	12.0
Avg. Yld.	2.0%	1.9%	1.7%	1.7%	1.9%	2.3%	3.2%	3.7%	3.7%	5.8%	4.3%	3.0%

IBM expects to generate diluted adjusted EPS of \$13.90 in 2019. Based on this, the stock trades for a P/E ratio of 10.9 that is below the historical 10-year valuation of approximately 12.0. The company appears to be undervalued at the present time. Our current fair value estimate is \$167 per share. Our five-year price target is \$193 share.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	21.5%	21.7%	22.2%	23.0%	24.8%	27.3%	36.8%	44.4%	49.0%	47.8%	49.9%	54.9%

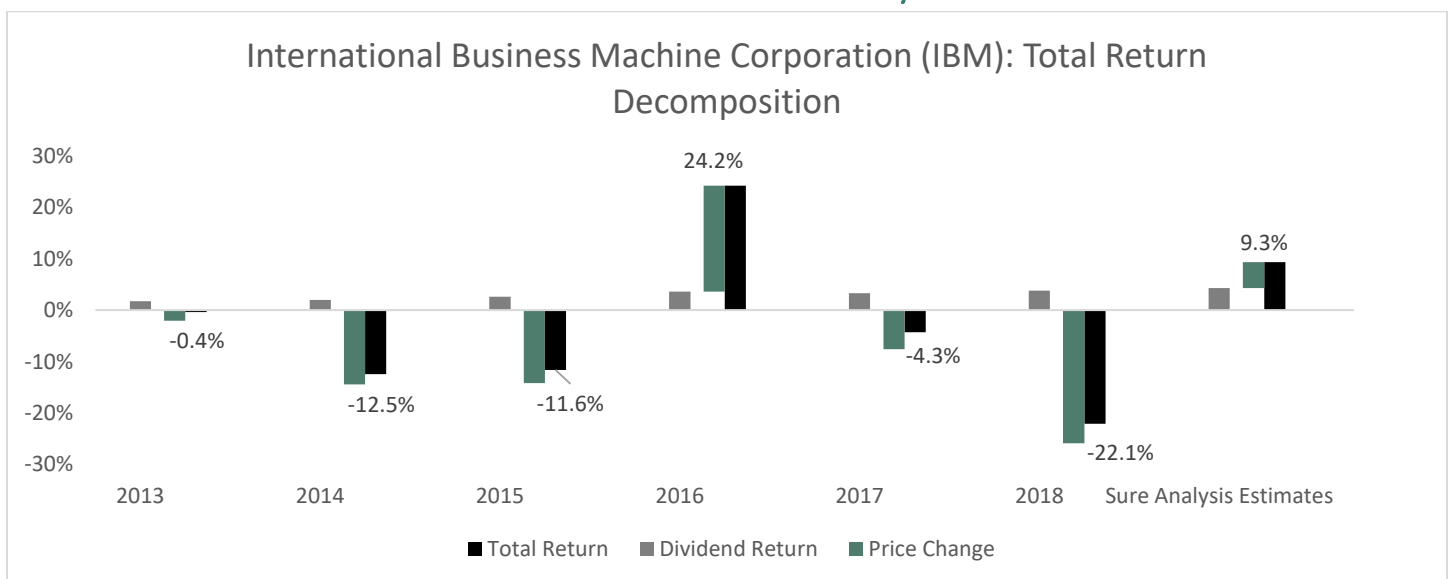
IBM's competitive strength is its brand, entrenched customer relations and extensive patent portfolio. IBM is a surprisingly recession-resistant company since the company has long-term service and maintenance contracts leading to recurring revenue. The nature of critical IT enterprise systems makes this unlikely to change in the near future. However, the company does face risks in that many of its competitors have head start in cloud and are growing faster.

IBM's balance sheet is reasonably conservative. IBM divides its debt into core debt and financing debt. The former is \$48.1 but is balanced by \$46.4B in cash in preparation for the Red Hat acquisition. The latter is used by the Global Financing segment and is \$25.0B but it is decreasing.

Final Thoughts & Recommendation

At present we are forecasting an 9.3% annualized total return for the next five years down since our last report due to stock price gains. This is comprised of 3.0% earnings growth, 4.3% dividend yield and 2.0% from P/E multiple expansion. If the Red Hat acquisition proves to be a catalyst for top and bottom line growth our estimates may well be low. The current dividend yield is attractive for those seeking income. Furthermore, the payout ratio is conservative. We currently rate IBM a buy at the current stock price.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue (\$B)	95.76	99.87	106.92	102.87	98.37	92.79	81.74	79.92	79.14	79.59
Gross Profit	43785	46014	50138	50361	48684	46407	40684	38516	36943	36936
Gross Margin	45.7%	46.1%	46.9%	49.0%	49.5%	50.0%	49.8%	48.2%	46.7%	46.4%
SG&A Exp.	20521	21545	23217	23085	22924	22472	19894	20279	19128	18863
D&A Exp.	4994	4831	4815	4676	4678	4492	3855	4381	4541	4480
Operating Profit	17012	19304	21394	22156	20313	18532	15690	13552	13140	13218
Op. Margin	17.8%	19.3%	20.0%	21.5%	20.7%	20.0%	19.2%	17.0%	16.6%	16.6%
Net Profit	13425	14833	15855	16604	16483	12022	13190	11872	5753	8728
Net Margin	14.0%	14.9%	14.8%	16.1%	16.8%	13.0%	16.1%	14.9%	7.3%	11.0%
Free Cash Flow	16696	14795	15179	14869	13345	12685	13104	12934	12951	11283
Income Tax	4713	4890	5148	5541	3363	4234	2581	449	5642	2619

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets (\$B)	109.02	113.45	116.43	119.21	126.22	117.27	110.50	117.47	125.36	123.38
Cash & Equivalents	12183	10661	11922	10412	10716	8476	7686	7826	11972	11379
Acc. Receivable	11879	11968	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Inventories	2494	2450	2595	2287	2310	2103	1551	1553	1583	1682
Goodwill & Int.	22703	28624	29607	33034	35055	33659	35507	40888	40529	39353
Total Liab. (\$B)	86.27	90.28	96.20	100.23	103.29	105.26	96.07	99.08	107.63	106.45
Accounts Payable	7436	7804	8517	7952	7461	6864	6028	6209	6451	6558
Long-Term Debt	26100	28624	31322	33270	39719	40722	39889	42168	46823	45812
Total Equity	22637	23046	20138	18860	22792	11868	14262	18246	17594	16796
D/E Ratio	1.15	1.24	1.56	1.76	1.74	3.43	2.80	2.31	2.66	2.73

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	12.3%	13.3%	13.8%	14.1%	13.4%	9.9%	11.6%	10.4%	4.7%	7.0%
Return on Equity	74.4%	64.9%	73.4%	85.2%	79.1%	69.4%	101.0%	73.0%	32.1%	50.8%
ROIC	27.9%	29.5%	30.7%	32.0%	28.7%	20.8%	24.6%	20.7%	9.2%	13.7%
Shares Out.	1305	1228	1163	1117	1054	990	965	946	922	892
Revenue/Share	71.39	77.58	88.09	89.03	89.18	91.87	83.18	83.36	84.43	86.86
FCF/Share	12.45	11.49	12.51	12.87	12.10	12.56	13.33	13.49	13.82	12.31

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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